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FEDERAL COMMUNICATIONS COMMISSION
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Price Cap Regulation of Local Exchange Carriers	)	CC Docket No. 93-179
	)	
Rate of Return Sharing And Lower Formula Adjustment	)	

COMMENTS

U S WEST Communications, Inc. ("U S WEST"), through counsel and pursuant to the Federal Communications Commission's ("Commission") Notice of Proposed Rulemaking,[1] hereby files its comments on the Commission's "add-back" proposal.

I. INTRODUCTION

In its Notice, the Commission notes that existing price cap rules do not address the issue of how sharing amounts or low-end adjustment amounts (i.e., as a result of the previous year's earnings) should be treated in calculating local exchange carrier ("LEC") earnings for the current year.[2] In proposing that sharing and low-end adjustment amounts be "added back" to calculate LEC earnings, the Commission observes that "under rate of return regulation we have required LECs to 'add-back' an

[1] In the Matter of Price Cap Regulation of Local Exchange Carriers, Rate of Return Sharing and Lower Formula Adjustment, CC Docket No. 93-179, Notice of Proposed Rulemaking, rel. July 6, 1993 ("Notice" or "NPRM").

[2] Id. at ¶ 4.

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adjustment for rate of return-based refunds from prior periods."[3] Under its "add-back" proposal, the Commission would require price cap LECs to exclude from base period earnings "amounts associated with exogenous adjustments to the [Price Cap Index] PCI for the sharing or lower formula adjustment mechanisms."[4] The net effect of the proposed rule change is that a sharing or low-end adjustment in a single year could lead to subsequent adjustments over a series of years.

Thus, in proposing to "add back" sharing and low-end adjustment amounts, the Commission is abandoning the price cap

II. PRICE CAP ADJUSTMENTS WERE INTENDED TO BE ONE-TIME ADJUSTMENTS ONLY

U S WEST does not believe that in adopting price cap regulation the Commission ever intended sharing and low-end adjustments to have an effect beyond one year. In discussing sharing in its original Price Cap Order, the Commission was quite clear as to its intent in adopting a sharing mechanism:

> Furthermore, the sharing mechanism operates only as a one-time adjustment to a single year's rates, so a LEC would not risk affecting future earnings, as it would in the case of the stabilizer we had previously considered.[6]

With its "add-back" proposal, the Commission is effectively proposing to abandon the price cap concept of one-time adjustments.

III. "SHARING" CANNOT BE EQUATED TO A "REFUND"

Throughout its NPRM, the Commission implies that sharing under price cap regulation is the equivalent of a refund under rate of return regulation.[7] U S WEST disagrees. Sharing and refunds are the products of totally different regulatory regimes. Price cap regulation is incentive-based regulation which limits price changes and rewards LECs for productivity improvements. Rate of return regulation, on the other hand, is basically "cost-plus" regulation where LEC rates are established based on costs

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[6] Id. at 6803 ¶ 136.

[7] E.g., see NPRM at ¶ 8.

including a prescribed return on capital. A refund under rate of return regulation is the product of "overearnings" and is based on a finding that rates are unlawfully high. Under price cap regulation, there is no such thing as "overearnings."[8] The sharing and low-end adjustment mechanisms were adopted due to variations in LEC productivity, not to limit LEC earnings.[9] In fact, the interstate price cap plan for AT&T has never contained a sharing or low-end adjustment mechanism.

Thus, the only connection between sharing and earnings under price cap regulation is via LEC productivity changes. The Commission's NPRM and "add-back" proposal appear to be aimed at controlling LEC earnings.[10] This is at odds with the underlying precepts of price cap regulation. Customers are already fully protected through pricing restrictions and annual productivity offsets -- the Commission's add-back proposal only reintroduces

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[8]Even in the 100% sharing range, rates which comply with the price cap rules are presumed to be just and reasonable. This is quite different from traditional rate of return regulation where refunds and overearnings are associated with unreasonable rates. There is no such parallel under price cap regulation. See Price Cap Order, 5 FCC Rcd. at 6802 ¶ 128.

[9]"In recognition of the difficulty of determining a single, industry-wide productivity offset that will be accurate for all LECs, the Commission adopted sharing and adjustment mechanisms to adjust rates in the event of unanticipated errors in the price cap formula." In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, Order on Reconsideration, 6 FCC Rcd. 2637, 2676 ¶ 86 (1991). Also, see Price Cap Order, 5 FCC Rcd. at 6801 ¶ 120.

[10]One of the reasons the Commission cites as justifying add-back is that "without add-back, artificial swings in earnings can occur." NPRM at ¶ 12.

old rate of return disincentives.[11] Rather than adopting the add-back proposal, the Commission should consider eliminating the sharing and low-end adjustment mechanisms in their entirety. These mechanisms are the last vestiges of rate of return regulation and have no place in an incentive-based price cap plan.

IV. THE COMMISSION'S "ADD-BACK" PROPOSAL IS A SUBSTANTIVE RULE CHANGE WHICH CANNOT BE APPLIED RETROACTIVELY

The Commission's "add-back" proposal is a substantive change in the Commission's existing price cap rules. Throughout the NPRM, statements are made such as "the add-back adjustment should continue to be part of the rate of return calculations of LECs subject to price caps"[12] and the NPRM all but openly asserts that LECs are required to employ the add-back approach under current price cap rules. U S WEST disagrees. The Commission's add-back proposal is a substantive change in the price cap rules which cannot be applied retroactively to LECs.[13] The Commission must agree with this position -- since it initiated this

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[11] The Commission recognized this in its NPRM when it observed that "[B]y reducing the range of earnings permitted under the backstop, however, add-back does reduce the efficiency incentives." Id. at ¶ 14.

[12] See id. at ¶ 15.

[13] The Commission would be engaging in retroactive rulemaking if it required LECs to employ the "add-back" approach to other than prospective sharing and low-end adjustments. See Bowen v. Georgetown University Hospital, 109 S. Ct. 468, 471-72 (1988).

rulemaking.[14] It is U S WEST's position that LECs cannot be lawfully required to "add-back" sharing and low-end adjustment amounts under current price cap rules. The fact that the Commission required LECs to add back refunds under rate of return regulation is not relevant to how sharing and low-end adjustment amounts should be calculated under price cap regulation.

V. ALL SHARING AND LOW-END ADJUSTMENTS MUST BE APPLIED TO PCIs, NOT APIs

Under price cap regulation, LECs may price below their Price Cap Indices ("PCI"). When this occurs, LEC Actual Price Indices ("API") are less than their PCIs. If a LEC is priced below its PCI, it is free to increase its rates to the cap at any time on 14 days' notice. All applicable sharing and low-end adjustment amounts are applied to a LEC's PCI, not its API. Even with a sharing adjustment, a LEC may not be required to lower rates if it is already priced sufficiently below its PCI. Clearly, it would make no sense to apply such adjustments to a LEC's API. To do so would penalize LECs for pricing below their PCIs and incent LECs to price at the cap.

Therefore, if the Commission modifies its rules to incorporate "add-back" requirements, any subsequent sharing and low-end adjustments (i.e., as a result of an "add back") should be treated in the same manner as any other sharing or low-end

[14] At the very least, the Commission should delay consideration of such a change until completion of the LEC price cap review scheduled to begin in early 1994.

adjustment and be applied to LEC PCIs. With sharing, this is relatively straightforward and easily understood. The situation is more complicated where a LEC is pricing below its PCI and also qualifies for a low-end adjustment. In such a case, either the LEC has been subjected to a highly unusual event of great magnitude or it is unable to raise prices due to competitive pressures. In the latter case, a low-end adjustment still would not allow a LEC to raise its actual prices, only its PCI. In such a situation, the LEC must reduce its costs if it wishes to increase its earnings. Calculation of the amount of credit for the low-end adjustment amount in such circumstances becomes an academic exercise of little relevance to the LEC. In summary, U S WEST believes that all sharing and low-end adjustments should be as simple as possible and applied to PCIs.

VI. THE COMMISSION'S "ADD-BACK" PROPOSAL PERVERSELY AFFECTS LECs PRICING BELOW THEIR PCIs

In attempting to demonstrate the reasonableness of its "add-back" proposal, the Commission constructed a number of

TABLE 1

	Year 1	Year 2	Year 3	Year 4
Revenues	2425	2425	2425	2425
Expenses	1000	1000	1000	1000
Rate Base	10,000	10,000	10,000	10,000
ROR	14.25%	14.25%	14.25%	14.25%
Add-Back	0	100	150	175
Revenues With Add-Back	2425	2525	2575	2600
ROR With Add-Back	14.25%	15.25%	15.75%	16.0%
Sharing	100	150	175	187.5
PCI(t)	100.0	95.9	93.8	92.8
API(t)	90.0	90.0	90.0	90.0

This table illustrates that two things occur when a LEC continues to be priced below its PCI after sharing add-backs, *ceteris paribus*: 1) the calculated rate of return continues to rise in subsequent years; and 2) the sharing amount continues to increase even though operational results (*i.e.*, revenues, expenses, and rate base) remain unchanged.[15] At some point in time, the hypothetical LEC's API and PCI will become equal. When this occurs, the LEC will be forced to reduce prices by a disproportionate amount in the next tariff year. This result is totally contrary to the philosophy of incentive-based price cap regulation and one-time sharing and low-end adjustments.[16]

It is an understatement to say that the Commission's "add-back" proposal discourages LECs from pricing below their PCIs.

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[15]The calculated rate of return with add-back increases from 14.25% to 16.0% with no change in operating results. Similarly, the sharing adjustment grows from 100 in Year 1 to 187.5 in Year 4 with no change in operating results. Clearly, the "add-

The "add-back" approach represents a major step backward toward rate of return regulation. Rather than serving the public interest, the Commission's "add-back" proposal is contrary to the public interest and reintroduces old rate of return disincentives. At a minimum, the Commission should revise its proposal to limit the "add back" to the amount that prices were actually changed as a result of a sharing or low-end adjustment.

VII. CONCLUSION

For the foregoing reasons, U S WEST opposes the Commission's "add-back" proposal and urges the Commission to refrain from adopting any such requirement until after completion of the LEC

CERTIFICATE OF SERVICE

I, Kelseau Powe, Jr., do hereby certify that on this 2nd day of August, 1993, I have caused a copy of the foregoing **COMMENTS** to be served via first-class United States Mail, postage prepaid, upon the persons listed on the attached service list.

Kelseau Powe, Jr.

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***Via Hand-Delivery**

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